Asset Allocation Report – June 2019 Quarter

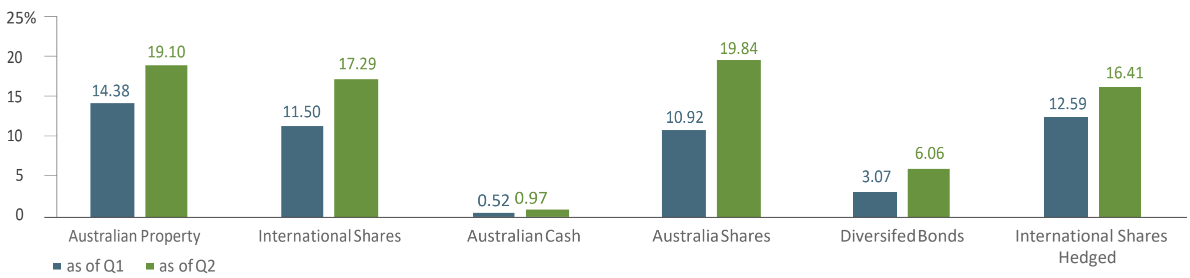
Quarter in Review

Anyone hoping for an eventful second quarter was not disappointed.

The US yield curve flirted with inversion, China economic data softened, and both the RBA and RBNZ cut cash rates. The Brexit plan became more uncertain, markets began speculating about potential 'insurance' rate cuts by the Federal Reserve, and trade tensions continued to simmer.

One would be forgiven for looking at the year-to-date market returns in disbelief. Even after a couple of volatile trading days, returns through 30 June for international and Australian shares were just shy of 20%. Market returns – except cash – do not appear drastically different from what they are in good economic times.

Figure 1: 2019 Q1-Q2 market returns for shares may surprise your clients



Notes: Australian Property represented by the S&P/ASX 300 A-REIT Index, International Shares by the MSCI World ex-Australia Index, Australian Cash by the Bloomberg AusBond Bank Bill Index, Australia Shares by the S&P/ASX 300 Index, Diversifed Bonds by a composite (30% Bloomberg AusBond Composite 0+ Yr Index, 70% Bloomberg Barclays Global Aggregate Float-Adjusted Index hedged to AUD), and International Shares Hedged by the MSCI World ex-Australia Index hedged to AUD.
Source: Vanguard.

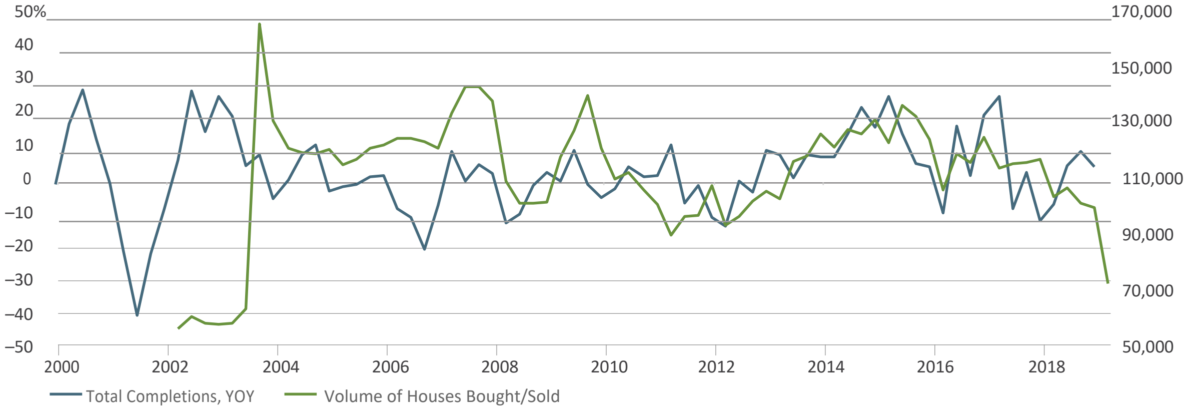
Economic outlook

Not much has changed from the past quarter: unemployment rates are still low and inflation is below most central banks' targets. Trade activity has deteriorated as businesses pull back and watch the US-China trade dispute unfold.

Locally, the same story holds. Interestingly, while the uptick in the unemployment rate (from 5.0% to 5.2%) is seen as a bearish signal, labour force participation reaching an historical high (66.0%) is cast aside in the haste to join the chorus of negativity.

While steady declines in residential property prices garner widespread attention, the volume of property transactions has not. Fewer properties are changing hands, depressing stamp duties, brokerage commissions, and other business revenues. While high household leverage and tighter credit are likely factors, we wonder if the market is still working off the multi-year construction boom. In thinking of property as an investment, the data suggest that few buyers are willing to pay for property at current price levels.

Figure 2: Property transactions are at an all-time low



Source: Vanguard calculations, using data from the Australian Bureau of Statistics.

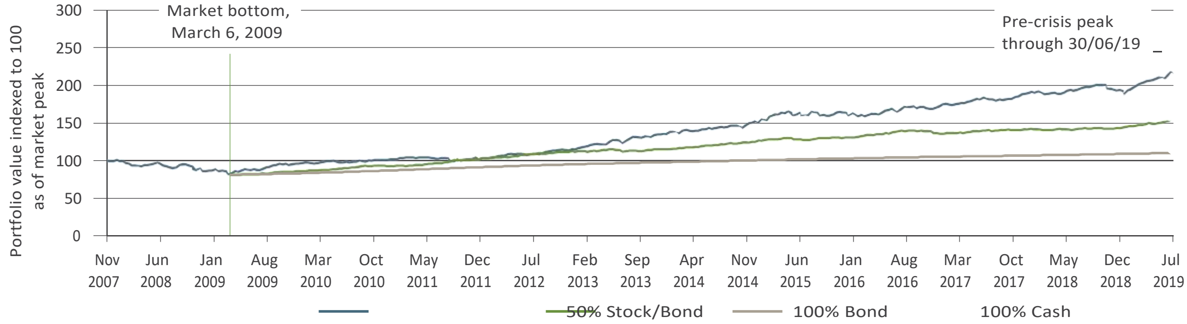
What can investors control?

Beyond the near term, we should continue to anticipate surprises. Slight changes in long-term return forecasts are not enough to justify a wholesale change to portfolio strategy. We'd caution investors against taking the bait and timing markets, lest one emotional decision compounds into a costly habit.

"Stay the course. No matter what happens, stick to your program." John C Bogle, founder of Vanguard, famously stated that this was the most important single piece of investment wisdom he could give to anyone.

As Figure 3 illustrates, staying the course has its rewards. Australian investors who stuck with a 50/50 stock/ bond portfolio have come out well ahead of those who sold out for bonds or cash at the bottom of the market. When the urge to change is strongest, the benefit is usually the weakest.

Figure 3: 'Staying the course' rewarded those who stuck with their stock/bond portfolio



Notes: 1 Nov 2007 represents the Australian equity peak of the period, and has been indexed to 100. Assumes all dividends and income are reinvested. Equity portfolio formed with 40% Aus Equity, 60% Intl Equity. Bond portfolio formed with 30% Aus Bonds, 70% Intl Bonds. Portfolios rebalanced monthly. All returns in AUD: Aus Equity - ASX 300; Intl Equity - MSCI World ex-Aus unhedged; Aus Bonds - Bloomberg AusBond Composite 0+ Yr; Intl Bonds – Bloomberg Barclays Global Aggregate Index Hedged to AUD to March 31, 2019, Bloomberg Barclays Global Aggregate Float-Adjusted Index Hedged to AUD thereafter; Cash - Bloomberg AusBond Bank Bill Index.

Source: FactSet. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

IWP and Vanguard Economic and Market Outlook? [i]

Down but not out

Our ten-year outlook (2019–2028) for investment returns remains guarded, given elevated valuations and low interest rates across major markets. With global growth set to slow and a number of risks on the horizon, investors should remain focused on what they can do to contribute to their investment success.

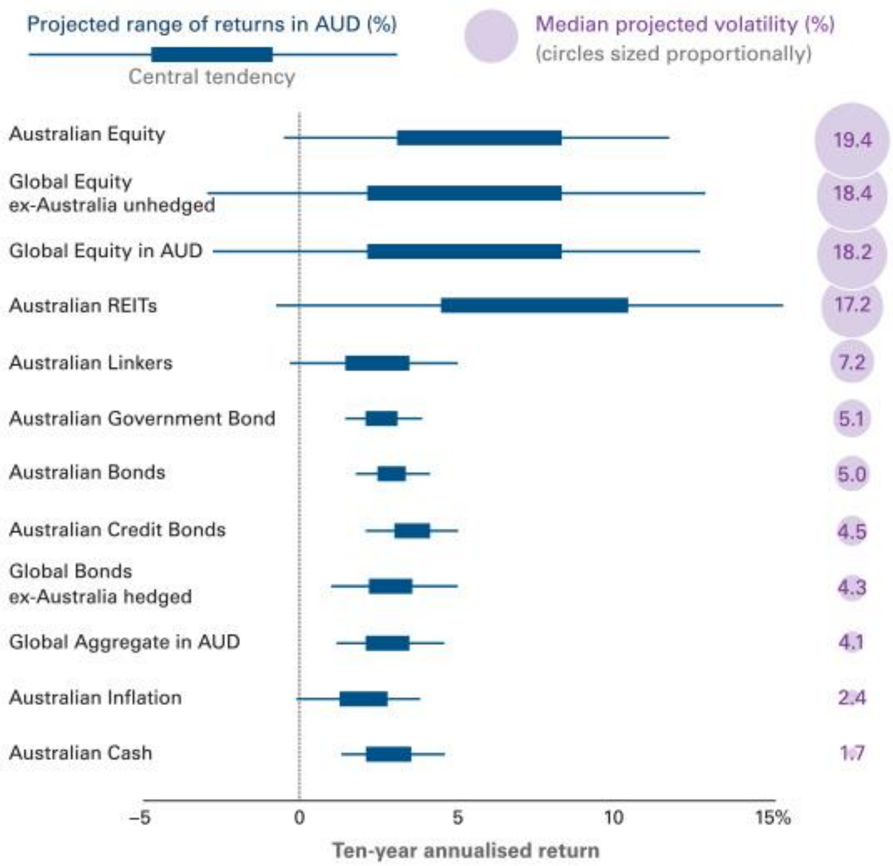
Investment outlook

Expect lower returns for the next decade

Changing strategies may not help much

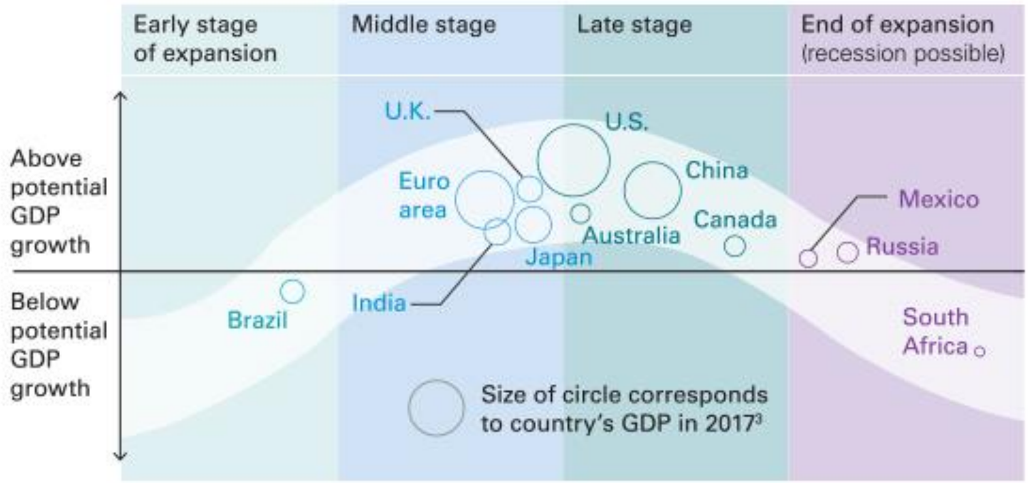
Outlook by sub-asset class: No pain, no gain

Over the next decade, risk will come with higher volatility, but not necessarily proportionally higher returns.



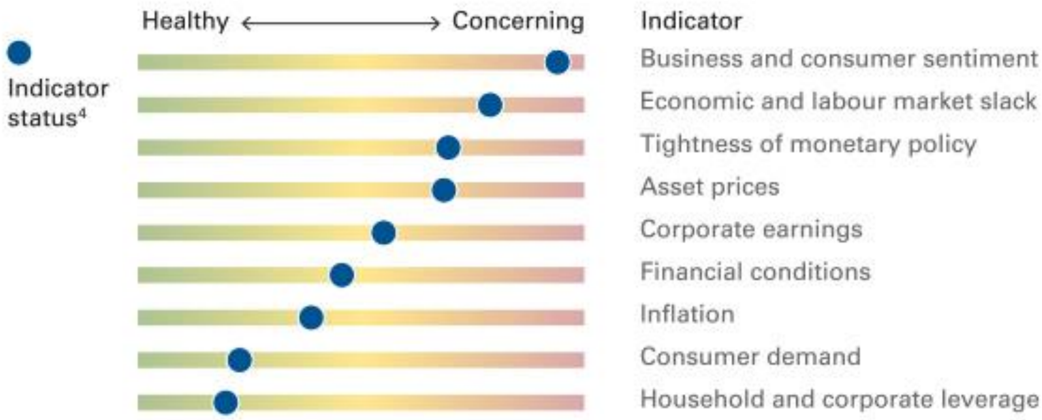
Global and regional economic outlook

Is a global recession imminent? Risks have risen, but many countries, including the U.S., are not at the end of their economic expansion.

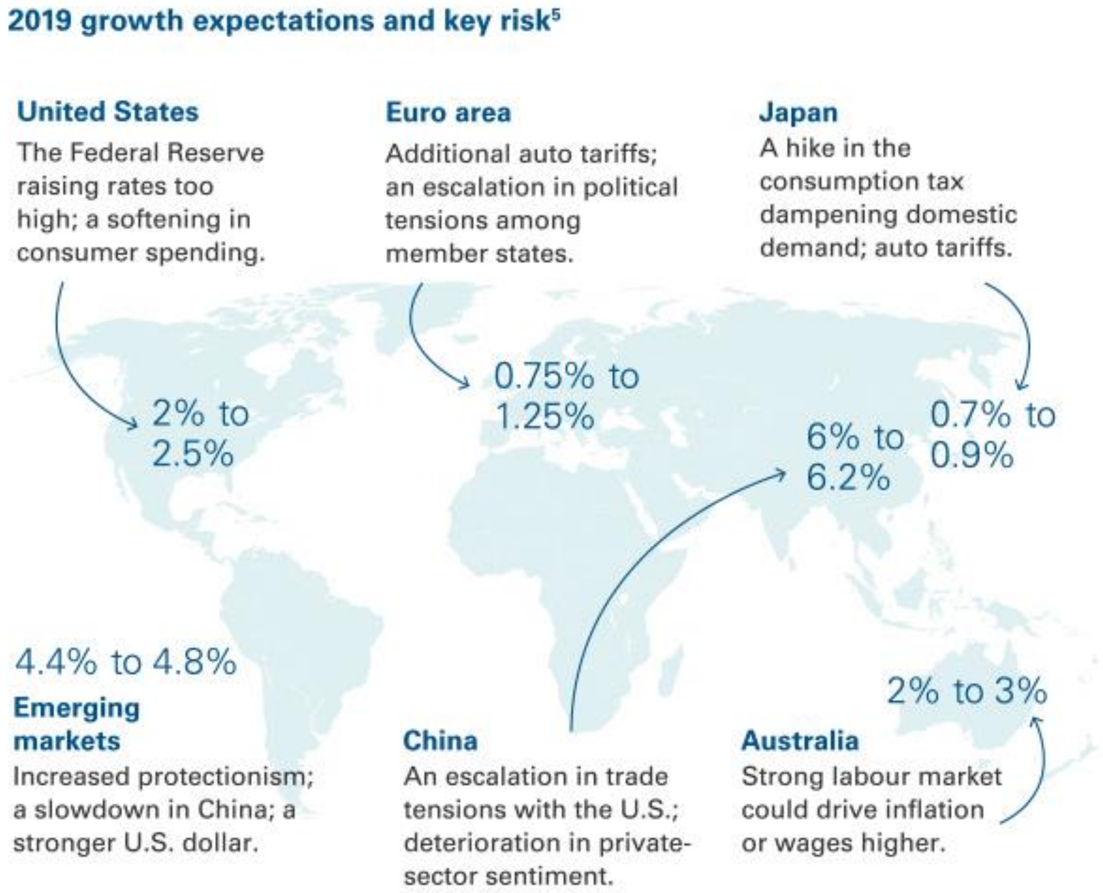


U.S. indicators as a whole are not flashing red

Although a few of these indicators are consistent with a slowdown, most suggest that the economic recovery—now in its tenth year—could persist at least through 2020.



Bottom line: Growth is slowing but not stalling



Summary

Although the risk has increased over time which has been recognised through this report, what is important is staying the course with your chosen risk profile, maintaining discipline and consistency through your investment strategy and having low cost access to markets

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[i] This information has been sourced from our Investment Partner – Vanguard Investment Australia, which is part of Vanguard Global, the 2nd largest asset manager in the world managing approximately 4.9 trillion dollars.